Voya Global Perspectives

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Executive Summary

- Markets are fixated on the gathering storm clouds over Europe, China and now the U.S.
- Meanwhile, consumer growth advancing unabated and corporate earnings still setting record highs
- A close look at "Big 3" (Europe, China and the U.S.) manufacturing can provide a vivid picture of their respective outlooks for the global economy and future corporate earnings
- Despite manufacturing woes, the U.S. consumer's exorbitant strength is stepping into the void
- While investors see constant negative headlines, the market keeps challenging all-time record highs

3rd Quarter Update: Storm Clouds Gathering

The gathering storm clouds that first began forming across Europe, and then China are now developing over the U.S. In Europe, it seems imminent that the third quarter will signal a recession; China has its hands full with the U.S. supply chain; and the U.S. suffered a substantial negative surprise in its very important manufacturing sector. Meanwhile, the consumer sector continues unabated and corporate earnings are still reaching record highs. Right now though, markets are focused on the impending storm.

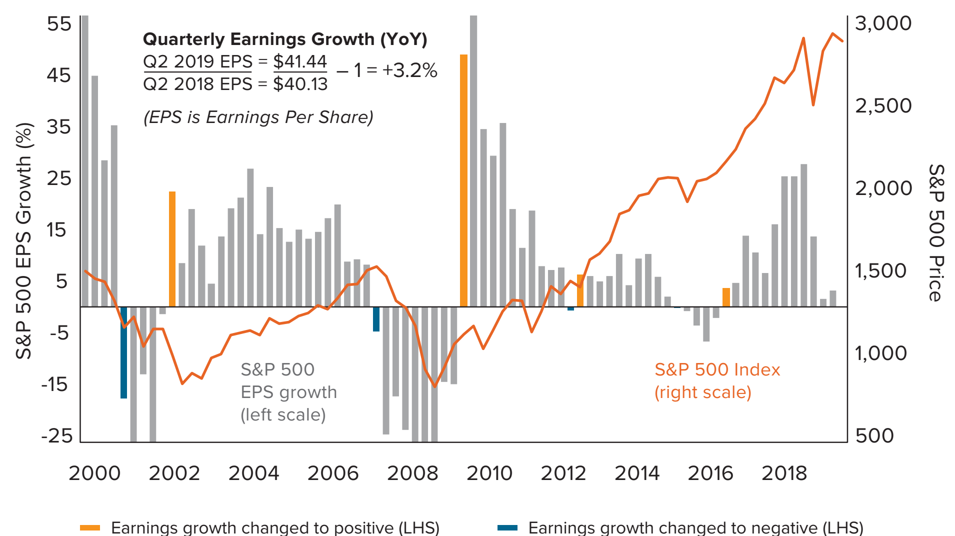
Manufacturing and the Big Three

With manufacturing being a pillar of the global economy, especially as it relates to trade, we think a closer look at the sector within the "Big 3" (Europe, China and the U.S.) can provide a vivid picture of their respective outlooks for the global economy and future corporate earnings.

Europe.

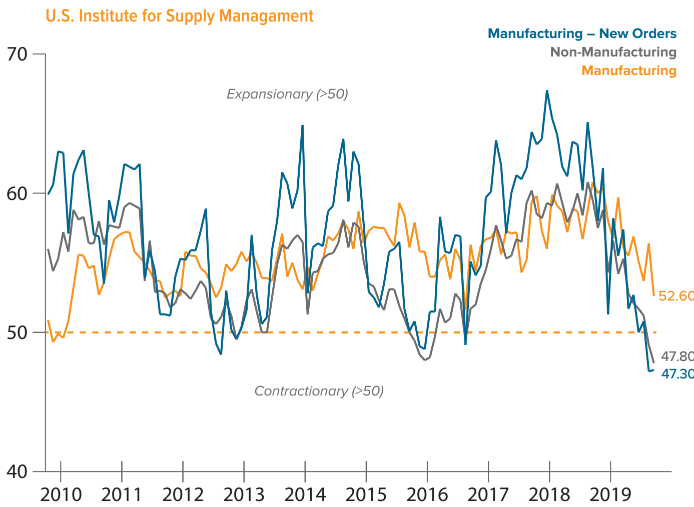
There are a lot of reasons why Europe is likely to enter a recession, but the biggest is their apparent distaste for pro-growth economic policies. The European Union and its member countries have excessive regulations and high taxes, both of which conspire to discourage the formation of capital and new businesses. We discussed a couple of years ago that the 2017 U.S. corporate income tax cut, in effect, made Europe less competitive on the world's stage. We expected a response from them to counter these "game-changing" tax cuts, but none was forthcoming and the proverbial rooster has come home to roost.

Figure 1. Fundamentals Drive the Market



Source: Standard & Poor's

Figure 2. Manufacturing is a good barometer for future corporate earnings growth and is struggling lately amid global trade tensions



Source: Institute of Supply Management, FactSet. The Purchasing Managers' Index (PMI) is an indicator of economic activity in the manufacturing sector. Measures above 50 indicate economic expansion, measures below 50 indicate economic contraction. Data as of 09/30/19.

China.

China seeks to play on the world stage, yet by their own undemocratic, authoritarian rules. In our view, there seems to be only one bi-partisan issue in U.S. politics today, which is the concerted effort to "get China". Furthermore, it appears that every other country in the world is rooting against China also, either openly or in private.

According to folklore, *China can wait 1,000 years, and this too shall pass*. That may be true, but when the global industrial complex is either drawing up plans to leave China or foregoing plans to enter China, we think the end is near for their capitulation. Closer to home for the Chinese government is that the unrest in Hong Kong appears to be spilling over and engendering a growing defiance in Taiwan. Indeed, China's manufacturing is very important to global growth and we wish them well in becoming an accepted part of the international community by playing by the rules.

The U.S.

The September reading of ISM Manufacturing was a surprise and a disaster. At just 12%, U.S. manufacturing punches far above its meager weight in the economy. In fact, the service-economy jobs associated with manufacturing has been thought to be double or more. Manufacturing is so important we have called it "the second derivative" of corporate earnings. Therefore, when ISM manufacturing goes negative, corporate earnings are often quick to follow.

However, this time may be different. Although ISM is our manufacturing indicator, Nancy Lazar of research firm Cornerstone Macro has another view. Nancy points out in her latest note that while ISM weakness has been largely driven by trade war-driven uncertainty and dollar strength, the Markit PMI, which is constructed differently with a more domestic U.S. focus, is less sensitive to foreign activity, i.e. the dollar. She points out that it has held above 50, rising in August and September.

The Consumer as the Gamechanger

While the consumer has long been roughly two-thirds of the U.S. economy, the current time is different due to exceptionally strong job growth and elevated consumer confidence. So far, the manufacturing malaise spillover has been limited. Currently at 70% of the U.S. economy, the consumers is the largest contributor by far of economic growth. In fact:

- Household wealth surged to an all-time high of $113.5 trillion.
- Jobs are plentiful with an all-time record high of 7.2 million openings.
- The U.S. has the lowest unemployment levels in 50 years, and on average adding north of 150K jobs per month.
- Housing is bouncing back with new starts up 12%, to an annual rate of 1.36 million, the highest since June 2007.
- Productivity, the key to sustained future GDP growth, has surged following the tax reform of 2017.
- Low gas prices and rock bottom mortgage rates continue to strengthen consumer spending and sentiment.

Indeed, the consumer alone may hold growth together until manufacturing recovers, and we strongly believe it will recover.

Market Review 3Q19

Investors were caught in the fog of divergent economic data in Q3:

- The S&P 500 seesawed throughout the quarter – positive in July, negative in August, positive in September, ending the quarter up 1.7% and 20.6% for the year so far;
- Defensive REITs rose as interest rates sank;
- Smallcap and midcap equities had a negative quarter, but ended with a strong September;
- EAFE stocks were negative as European economic data continued to significantly disappoint, prompting the ECB to return to the stimulus trough;
- Emerging markets were also down for the quarter due to declining China economics, diminished risk appetitie and a notably stronger U.S. dollar.

Bonds across the board posted positive returns as uncertainty surrounding economic growth drove yields down to three-year lows.

- Long duration U.S. Treasuries appreciated another whopping 8.2% in the quarter, bringing their return to 20.2% for the year;
- Investment Grade and High Yield corporate bonds rose 3% and 1.3%, respectively;
- Global bonds did not participate in the bond gravy train and were flat for the quarter.

Global investors are gravitating toward the U.S. bond market in search of yield, as there is now more than $17 trillion in global sovereign debt with negative rates of return. A stronger dollar is also adding to the appeal of U.S. denominated bonds, and spreads still indicate a stable credit backdrop.

Figure 3. An equal-weighted global diversified portfolio beats the S&P 500 over a long period of time for much less risk

Index	3Q19	YTD	2018	2017	2016	2015	3 years	5 years	10 years
Equity									
S&P 500	1.7	20.6	1.4	-1.6	12.0	1.4	13.4	10.8	13.2
S&P Midcap	-0.1	17.9	1.2	-4.2	20.7	-2.2	9.4	8.9	12.6
S&P Smallcap	-0.2	13.5	1.1	-4.5	26.6	-2.0	9.3	9.9	13.0
Global REITs	4.9	20.7	0.4	1.9	5.0	0.1	6.6	7.8	9.5
EAFE	-1.0	13.3	-1.3	-2.6	1.5	-0.4	7.0	3.8	5.4
Emerging Markets	-4.1	6.2	-1.1	-4.8	11.6	-14.6	6.4	2.7	3.7
Average	0.2	15.4	0.3	-2.6	12.9	-3.0	8.7	7.3	9.6
Fixed Income									
Corporate	3.0	13.2	0.6	3.1	6.1	-0.7	4.5	4.7	5.6
U.S. Treasury 20+	8.2	20.2	0.2	10.8	1.4	-1.6	4.1	7.0	7.0
Global Aggregate	0.7	6.3	-0.3	2.0	2.1	-3.2	1.6	2.0	2.3
High Yield	1.3	11.4	0.6	0.4	17.1	-4.5	6.1	5.4	7.9
Average	3.3	12.8	0.3	4.1	6.7	-2.5	4.1	4.8	5.7
Overall Average	**1.4**	**14.3**	**0.3**	**0.1**	**10.4**	**-2.8**	**6.8**	**6.3**	**8.0**

Source: FactSet, FTSE NAREIT, Voya Investment Management. The Overall Average model allocation includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds, Bloomberg Barclays U.S. High Yield Bonds. Returns are annualized for periods longer than one year. Past performance is no guarantee of future results. An investment cannot be made in an index.

Conclusion

It has to be hard for investors to see relentless negative headlines while the market keeps challenging all-time record highs. ISM was a disaster but the consumer is crushing it. The Federal Reserve at the end of last year was expected to raise as many as four times, and instead has cut rates twice and likely again in December – that's a virtual seven "rate increase" swing. Housing is surging with the help of super low interest rates and consumer wealth is at all-time record highs. On the corporate side, we have the lowest taxes in a century, a deregulatory frenzy, and a capital-intensive oil boom that will likely get bigger. Yes, storm clouds are indeed gathering, but do not forget nor discount the "the storm before the calm".

Diversification does not guarantee a profit or ensure against loss

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